LGIM America

2Q 2021

Market Commentary

Focus on the macro

These days investors are almost exclusively preoccupied with two “known unknowns”: inflation and the labor market. Among the most forecasted economic variables on the planet, their evolution over the next 6-12 months nevertheless looks unusually foggy. Investors are right to care. With equities ending the second quarter at the all-time highs and credit spreads at multi-decade lows, the starting point for valuations has not led to attractive risk-adjusted returns historically. At such lofty valuations, risk assets could be susceptible to a shock with the most likely one coming from a pivot toward tighter monetary policy. It is in this context that elevated inflation and the speed of the labor market recovery matters. Persistent inflation and a speedier-than-expected rebound in jobs could challenge the Fed’s current policy stance and result in a more volatile second half of the year.

In recent weeks it has become increasingly apparent that the range of economic opinions among members of the Fed is getting wider as the year progresses. The June dot plot was the first indication that several Fed officials now expect an earlier liftoff. While much of the attention focused on the 2023 median dot going from zero hikes to two, the fact that seven committee members now see cause for at least one hike next year is an important development. It would now take just two members to change their 2022 dot for the median dot to move to one hike next year, and thus challenge the notion that asset purchases can be tapered at a gradual pace.

Presumably, it is the dynamics around inflation that are getting the attention of some members of the Fed. This year’s inflation numbers were always expected to come in elevated due to the nature of year-over-year comparisons. However, most economists would likely concede that core measures of inflation have still managed to come in well-above expectations over the past three months while the commentary around supply bottlenecks suggests that transitory price pressures could persist into next year. Even the Fed has been forced to revise their forecast for core PCE up to 3% at year end, a level that is well above target.

What happens to inflation in 2022 is the key known unknown. So far, Chair Powell and Vice Chair Clarida have done an exceptional job at soothing markets throughout the inflation spike given their expectation that core PCE will fall back to 2.1% next year. Yet their task could get complicated over the next few months if price pressures were to broaden out from the goods sector to services and shelter. Wages are already showing signs of being firmer than expected in this cycle. Should that trend continue throughout the remainder of the year, it is likely to show up in services inflation as companies are indicating that they will pass along rising costs to consumers. Likewise, rental inflation has been running well-below the pre-pandemic pace and a rebound could materialize as forbearance measures expire.

Meanwhile, the labor market rebound has so far surprised in the other direction. Hopes that a stimulus-accelerated recovery would result in a rapid snap back to pre-pandemic levels of employment seem misplaced for the time being. At a pace of roughly 550 thousand per month, the three-month average of seasonally-adjusted payroll gains is well below that which would be required to return the US economy to maximum employment, at least before 2024. While the Fed would no doubt like to see a swifter recovery, the disappointing pace of hiring takes the pressure off to begin tapering sooner. Indeed, were the US economy adding 1 million jobs per month, the unemployment rate could be back to a pre-pandemic level by March of next year – a level that would surely question the necessity of $120 billion per month of asset purchases and holding rates at zero.

In any case, it is far too soon to know whether the current pace of job creation will persist. In fact, there are reasons to expect that the risk – from a Fed policy perspective – is toward a reacceleration in hiring in the Fall. The record number of job openings and survey data strongly suggest that the lackluster payroll gains are not due to insufficient demand for labor but rather the lack of labor supply. Among other factors, the Fed itself has noted the combination of enhanced unemployment benefits, lingering COVID-19 health concerns, and childcare logistics seem to be holding back the supply of labor. Presumably, many of those issues will be resolved in the coming months and more workers will be looking to rejoin the workforce.

Yet, if there is one takeaway from the last year of economic forecasting, it is that a little bit of humility is in order. Love him or hate him, the late Donald Rumsfeld's "known unknowns" quote is probably as accurate a way to describe the current macroeconomic outlook as any. To a much greater degree than is typical, investors know inflation and the jobs market are likely to be the key drivers of risk asset performance over the coming months even if the path of each remains unknown.

Focus on fixed income

The sharp rise in interest rates that defined the beginning of 2021 underwent a notable reversal in the second quarter with 10- and 30-year yields ending the three-month period lower by 29 and 35 basis points, respectively. For many investors, the decline in long end rates came as a surprise against the backdrop of stronger than expected inflation data and already negative real rates. Surprisingly, it is difficult to point to one specific driver of the Treasury rally. Fundamentally, the move lower in yields may be motivated by the combination of slower than expected credit growth in China, continued dovishness from the ECB, a potentially smaller than anticipated infrastructure package in the US and the delta variant gaining a foothold worldwide. But pundits have also pointed to more technical considerations like one-sided positioning among investors and the ongoing run down of the Treasury General Account. Finally, Fed rhetoric seems to be playing a part too, judging by the decline in the 5y5y forward inflation rate from a mid-May high of 2.4% to end the quarter 20 basis points lower.

Often when interest rates move lower, credit spreads widen as yield sensitive buyers step back. However, that was not the case in the second quarter as volatility subsided and credit spreads managed to narrow. The Bloomberg Barclays US Credit Index ended the second quarter 9 basis points tighter at 76 basis points, while the Bloomberg Barclays US Long Credit Index finished 7 basis points tighter at 118 basis points. Ironically, the rally in Treasury yields has seemed to coincide with less mutual fund demand for credit. For much of the post-pandemic period, inflows to investment grade credit funds were running at a pace of roughly $5-6 billion per week. But over the last month and half, those flows have declined to a pace of just $2-3 billion per week, which would represent a significant loss in demand were it to persist.[1]

As credit spreads have continued to grind ever lower, valuations are becoming more of a concern. At 76 basis points, investment grade credit spreads have not been lower since February of 2007. Adjusted for duration and credit quality, credit spreads have not been lower since the late 1990s. Furthermore, as one would expect with overall spreads so tight, the compensation for moving down in credit quality has diminished substantially with BBBs and HY outperforming throughout the year. There are still catalyst-driven ideas to be found, as the outperformance of AT&T, General Electric and Energy Transfer during the quarter demonstrate. However, the case for being overweight beta within the investment grade market has weakened as the year has progressed. As such, the focus has been on reducing generic beta positions that lack a clear catalyst within the LGIM America portfolios while remaining defensively positioned overall.

Focus on client solutions

Heading into Q2, the consensus called for a continuation of the reflation theme as the peak of the pandemic moved, ostensibly, further in the rearview mirror. While market sentiment remains decidedly positive, as evidenced by continued strength in equity markets and credit spreads near historical tights, the upward momentum on interest rates experienced a surprising reversal over the last few months. Nonetheless, the economic recovery remains robust, buoyed by a supportive macroeconomic policy backdrop and further progress on the reopening of the economy.

While the typical pension plan's funding status notably improved in Q1, LGIM America estimates the average funding ratio declined modestly from 90.7% to 89.9% over Q2. The average plan benefited from continued strength in equities (global equities[2] and S&P 500 increased 7.5% and 8.6% respectively) resulting in plan assets with a traditional "60/40" asset allocation increasing 5.2% in total.[3] However, discount rates declined by roughly 45 basis points over the quarter, contributing to higher liability values and an offset of robust global equity performance.

From a client perspective, interest in liability driven investment strategies remains firm despite the modest deterioration in funded status in Q2 as clients look to lock in year to date funded status gains. Tailored investment strategies such as completion management and custom credit solutions continue to gain traction.

However, the low interest rate environment remains a quandary for some clients, and the decline in rates over the last three months has only intensified this search for yield. Amidst the uptick in de-risking activity, there is a growing interest from clients and consultants to look at ways to expand the fixed income toolkit in search for higher yield and diversification to current fixed income allocations. One avenue of interest this year has been focused on assessing the merits of including US Private Placements ("USPPs") into a custom LDI strategy.[4]

We've also seen growing demand for derivative overlay strategies, specifically focusing on downside protection and equity replication as plans aim to improve capital efficiencies and defend against adverse market corrections.

Lastly, ESG investment frameworks have become a central topic for institutional clients. More specifically, integrating ESG objectives within strategic asset allocation is increasingly top of mind for consultants and clients we engage with.

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1. Source: Bloomberg
2. "Global equities" referred to here is represented by the MSCI AC World Total Gross Index
3. As represented by 60% MSCI AC World Total Gross Index/40% Bloomberg Barclays US Aggregate Index ("60/40")
4. USPPs are investment grade bonds issued outside the public bond market and are exempt from registration with the SEC. Issuers of USPPs tend to fall broadly into two sectors: 1) corporate and alternative finance, and 2) infrastructure finance. Within LGIM America, USPPs are part of the broader Private Credit asset class, which also includes investments in commercial mortgage loans.

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